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# Practical Guide to Forming a Closely-Held Corporation in Utah

*John W. Welch\**

## CHECKLIST OF QUESTIONS TO CONSIDER WHEN FORMING A CLOSELY- HELD CORPORATION

### *I. REGISTRATION AND ARTICLES OF INCORPORATION*

- ☐ 1. *What will be the legal name of the corporation?*
- ☐ 2. *What are the names and addresses of the incorporators?*
- ☐ 3. *What is the address of the corporation's principal place of business?*
- ☐ 4. *What is the name and address of the corporation's agent for service of process?*
- ☐ 5. *What is the nature of the business and what are the purposes of the corporation?*
- ☐ 6. *Should the state of incorporation be one other than Utah?*
- ☐ 7. *What quorum requirements should apply for shareholder meetings or directors meetings?*
- ☐ 8. *What percent of the voting stock is required to amend the articles or other provisions?*

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*II. SELECTION AND DUTIES OF DIRECTORS AND OFFICERS*

- ☐ 9. *What are the names and addresses of the initial directors?*
- ☐ 10. *What are the names and addresses of the initial officers?*

*III. RIGHTS AND DUTIES OF SHAREHOLDERS*

- ☐ 11. *What are the names and addresses of the initial shareholders?*
- ☐ 12. *What is the date and location of the annual shareholder meetings?*
- ☐ 13. *Will the shareholders have preemptive rights?*
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- ☐ 21. *To whom will the shares be issued and for what consideration?*
- ☐ 22. *Will the stock have par value?*
- ☐ 23. *Will the stock be subject to transfer restrictions?*
- ☐ 24. *Will the stock be subject to any buy-sell agreements?*

- ☐ 25. *Will any preference be given to certain shareholders in the distribution of current profits of the corporation?*
- ☐ 26. *Will any preferences or priorities be given to any shareholders upon liquidation?*
- ☐ 27. *Is it clear which stock will qualify as Section 1244 stock?*
- ☐ 28. *Do the securities laws apply to closely-held corporations?*

### INTRODUCTION

When a client asks an attorney to form a new corporation for a closely-held business in Utah, several questions need to be answered in order to complete the incorporation process efficiently and appropriately. This guide offers a checklist to speed this process and ensure that both the client and the attorney consider all the relevant and practical options available. This checklist may be given to the client to take home for consideration, or it can form the basis of a working conference and the drafting of a pre-incorporation agreement.

The accompanying annotations identify the main legal issues implicit in the checklist questions. The annotations explore pertinent statutes and points of law, the basic alternatives open to the incorporator in each case, some of the pitfalls that should be avoided, and how the client's answers to the questions should be reflected in the documents that the attorney prepares in completing the incorporation process.

## I. REGISTRATION AND ARTICLES OF INCORPORATION

### 1. *What will be the legal name of the corporation?*

The selection of the corporate name should not be a mindless exercise. As one authority has noted,

[the] name should be distinctive and should be adapted to advertising the business. Whenever possible, it should be related to a trademark or trade name to be used in the business. Preferably, it should describe the business, [it] should be short, easily pronounced and readily remembered. It should not contain personal names of the owners.<sup>1</sup>

The attorney has the duty to determine whether the name or names proposed by the client are the same as or similar to the name of any

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1. 1 F. HODGE O'NEAL & ROBERT B. THOMPSON, O'NEAL'S CLOSE CORPORATIONS § 2.12 (3d ed. 1992).

existing business. If the name or a diminutive thereof is to be used as a trademark, care must be used to ensure that the name is sufficiently unique to avoid any likelihood of confusion, which could lead to an injunction that would destroy any goodwill accumulated in the mark.

#### *A. Guidelines*

The following are several guidelines that should be considered in determining the name of the corporation:

- (1) When incorporating an existing business, the new corporate name should be as similar as possible to the preexisting business name.
- (2) The name should inform potential customers what the primary business of the corporation is and indicate its products and services.
- (3) Generally, an owner's name should not be used in the corporate name. However, if the corporation will operate in a community where the owner is known favorably, using that person's name in the corporate name merits consideration.
- (4) Check whether the proposed corporate name is available for use by contacting the secretary of state or other appropriate state official. In Utah, contact the Division of Corporations and Commercial Code.<sup>2</sup>
- (5) Consider the impression that the name will make on the consuming public or market, including the advertising potential.
- (6) Research the availability of the name, or diminutives thereof, as a trademark or service mark in the Federal Trademark Registry.<sup>3</sup> Also be sure to search the state registry of trademarks in the state of incorporation and all states in which future expansion is likely. This may or may not have already been accomplished when incorporating a previously-existing business.

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2. Second Floor, Heber M. Wells Building, 160 East 300 South, P.O. Box 45801, Salt Lake City, Utah 84145-0801 (801-530-4849).

3. For a practical discussion of trademark searches, see SIEGRUN D. KANE, TRADEMARK LAW: A PRACTITIONERS GUIDE 53 (1987).

- (7) Research the protectability of the name or diminutive as a trade name or trademark.<sup>4</sup> An "intent to use" trademark application should be filed with the Federal Patent and Trademark Office.<sup>5</sup>
- (8) It is best to avoid names having an actual meaning or adverse connotations in English or Spanish if the corporation plans to do business in the United States. The connotation of the name in other languages should be considered if the name is to be used abroad or in areas where the language is spoken in the United States.
- (9) Because a short name is more easily read, has more impact, and is more easily remembered than a long one, keep the name short if the name will be used in public marketing (i.e. IBM, Shell, Exxon, etc.).

*B. Utah statutory requirements<sup>6</sup>*

The following Utah statutory requirements need to be taken into account in determining the corporate name:

- (1) The names of corporations must contain the word "corporation," "company," or "incorporated," or the abbreviations "Corp.," "Co.," or "Inc.," or words of like meaning in another language.<sup>7</sup>
- (2) A corporate name may not contain any word or phrase that indicates that it is organized for any purposes other than those specified in its articles of incorporation. If the corporation is organized for all legal purposes, the name must not indicate the corporation is organized for an illegal purpose.<sup>8</sup>

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4. See David A. Westenberg, *What's in a Name? Establishing and Maintaining Trademark and Service Mark Rights*, 42 BUS. LAW. 65 (1986).

5. KANE, *supra* note 3. "Intent to use" applications are permitted by 15 U.S.C. § 1051(b)(1)(A) (1988).

6. No certificate of incorporation will be issued to any association violating the provisions of title 16 of the Utah Code. Application for a corporation name is made through the Division of Corporations and Commercial Code.

7. UTAH CODE ANN. § 16-10a-401(1)(a) (Supp. 1994).

8. *Id.* § 16-10a-401(1)(a)(1)(b).

- (3) The name must be legally distinguishable<sup>9</sup> from
  - (a) the name of any domestic profit or nonprofit corporation, limited liability company, or limited partnership existing under state law,
  - (b) the name of any foreign profit or nonprofit corporation, limited liability company, or limited partnership authorized to do business in the state,
  - (c) any name which is reserved or registered with the Division of Corporations and Commercial Code,
  - (d) the name of a general partnership which has registered its name,
  - (e) the name of any fictitious name, business name, assumed name, trademark or service mark registered by the Division of Corporations and Commercial Code,<sup>10</sup> or
  - (f) any name implying that the corporation is an agency of the state or any of its political subdivisions.<sup>11</sup>
- (4) When merging with or acquiring another corporation, a new corporation may use the name of that domestic or foreign corporation.<sup>12</sup>
- (5) Any person intending to incorporate may reserve a corporate name for 120 days.<sup>13</sup>

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9. The statute states that:

(5) (a) A name is distinguishable from other names, trademarks, and service marks on the records of the division if it contains one or more different letters or numerals, or if it has a different sequence of letters or numerals from the other names on the division's records. Differences between singular and plural forms of words are distinguishing.

(b) Differences which are not distinguishing are:

- (i) the words or abbreviations of the words "corporation," "incorporated," "limited partnership," "L.P.," "limited," "ltd.," "limited liability company," "limited company," "L.C.," or "L.L.C.;"
- (ii) the presence or absence of the words or symbols of the words "the," "and," or "a;"
- (iii) differences in punctuation and special characters; or
- (iv) differences in capitalization.

*Id.* § 16-10a-401(5)(a)-(b).

10. *Id.* § 16-10a-401(2).

11. *Id.* § 16-10a-401(6).

12. *Id.* § 16-10a-401(4).

13. *Id.* § 16-10a-402. Reserved names are transferrable and renewable. Reservation does not authorize the applicant to use the name until the name is registered as a trade name, articles of incorporation bearing the name are filed, or an application for authorization has been filed. *Id.* § 16-10a-402(3).

- (6) The Utah Code contains an explicit caveat that reserving a name, or filing articles of incorporation bearing a name, does not grant trademark rights in that name.<sup>14</sup>

2. *What are the names and addresses of the incorporators?*<sup>15</sup>

An incorporator is one who joins with others to form a corporation. Because no liability attaches to the role of incorporator in most states,<sup>16</sup> and the incorporator's function is completed upon incorporation,<sup>17</sup> an attorney usually acts as one of the incorporators. However, because of fiduciary duties and potential liabilities that directors incur, most attorneys do not serve as directors of corporations they helped incorporate.<sup>18</sup>

Utah law requires that one or more natural persons at least 18 years of age act as incorporators.<sup>19</sup> The incorporators do not have to be residents of the state.

The name and address of each incorporator must be included in the articles of incorporation.<sup>20</sup> A majority of the incorporators are required to call an organizational meeting of the board of directors, unless the initial board is named in the articles of incorporation.<sup>21</sup>

3. *What is the address of the corporation's principal place of business?*

A Utah corporation must have a principal office, which is listed on reports sent to the Division of Corporations and Commercial Code. Examples of such reports include the annual reports, an application for certificates of authority, or a notice of change in principal office.

The principal office serves a number of functions. First, it is the official repository of certain records for the corporation such as the bylaws, articles of incorporation, minutes of shareholder meetings, lists of the names and addresses of the officers and directors, annual reports, financial statements, and other documents.<sup>22</sup> These records must be

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14. *Id.* § 16-10a-403.

15. *See generally*, 1A WILLIAM MEADE FLETCHER, CYCLOPEDIA OF THE LAW OF PRIVATE CORPORATIONS § 81-90 (rev. perm. ed. 1993).

16. ROBERT W. HAMILTON, CASES AND MATERIALS ON CORPORATIONS INCLUDING PARTNERSHIPS AND LIMITED PARTNERSHIPS 166 (3d ed. 1986).

17. 1A FLETCHER, *supra* note 15, § 81.

18. *See* HAMILTON, *supra* note 16, at 166. Some of the fiduciary duties of the director are discussed *infra* question 9.

19. UTAH CODE ANN. § 16-10a-201 (Supp. 1994).

20. *Id.* § 16-10a-202(1)(f).

21. *Id.* § 16-10a-205.

22. *See, e.g., id.* § 16-10a-1601(5).



made available to shareholders for inspection at the principal office.<sup>23</sup> Second, the principal office is a place where the corporation can receive correspondence and written notice.<sup>24</sup> Third, the location of the principal office is used to determine jurisdiction over certain matters.<sup>25</sup> Finally, it is the locus of shareholder meetings if the bylaws do not state another place.<sup>26</sup>

4. *What is the name and address of the corporation's agent for service of process?*

The Utah Code requires that all corporations register an office and identify an agent who shall be responsible for receiving service of process, notice, or demand on behalf of the corporation.<sup>27</sup> This requirement is intended to facilitate communication with corporate directors and officers and provide an address for service of process, notice, or demand upon the corporation.

A registered agent shall be (1) an individual who resides in the state; (2) a domestic profit or non-profit corporation; (3) a foreign profit or non-profit corporation authorized to transact business in the state; or (4) a domestic limited liability company or a foreign limited liability company authorized to transact business in the state.<sup>28</sup> In each instance above, the agent's business office must be identical to the registered office, but not necessarily the principal place of business, which might be outside Utah.

5. *What is the nature of the business and what are the purposes of the corporation?*

A. *Generally*

Utah law requires that the articles of incorporation set forth the purpose or purposes of the business to be incorporated.<sup>29</sup> The purpose clause should express the nature and scope of the business as agreed upon among the incorporators or principals. Utah law permits a business to incorporate for the purpose of engaging "in any lawful act or activity," except for a business that is provided for under a special statute.<sup>30</sup>

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23. *Id.* § 16-10a-1602(1).

24. *See, e.g., id.* § 16-10a-504(2).

25. *See id.* §§ 16-10a-126(1), -703(1), -720(4), -1330(2), -1431(1), -1604(1).

26. *Id.* §§ 16-10a-701(2), -702(3).

27. *Id.* § 16-10a-202.

28. *Id.* § 16-10a-501(1).

29. *Id.* § 16-10a-202(1)(a).

30. *Id.* §§ 16-10a-202(3), -301.

Though broad, the purposes allowed are limited in several ways. The business purpose must (1) be one of which a corporate body is capable; (2) not violate constitutional limitations; and (3) not be obnoxious to law or public policy.<sup>31</sup> The Utah Code specifically governs the formation of certain corporations organized for particular purposes. The broadly worded clause "in any lawful business" does not furnish a means of evading such specific requirements.<sup>32</sup> Furthermore, the Utah Constitution prohibits the organization of individuals, except as otherwise provided by statute, to set up monopolies or restrain trade.<sup>33</sup>

### *B. Unauthorized and incompatible purposes*

When the purpose for which a corporation is formed is not authorized by statute, the attempted incorporation is generally held to be void.<sup>34</sup> Moreover, unauthorized provisions will be inoperative and any acts done in pursuance thereof will be void.<sup>35</sup>

### *C. Specific versus general purpose clauses*

In most situations a relatively general statement of purposes is preferable to a specific enumeration. A general purpose clause does not force the drafter to predict possible areas of future expansion. On the other hand, purpose clauses should be given particular attention if incorporation is under a statute which does not permit a general purpose clause. Furthermore, parties may wish to protect minority shareholders or to limit the scope of the business by limiting the purpose clause in the articles of incorporation. In such a situation, the purpose clause should be sufficiently definite to curb excursions into unauthorized ventures, yet sufficiently general to permit reasonable operations and expansion without the necessity of amending the articles in the future.

The Division of Corporations and Commercial Code may refuse an application for a corporate charter if the articles simply list any lawful purpose as the corporate purpose. The Division strongly prefers a specific purpose clause followed by a general residual clause because a specific clause better facilitates the coding and classification of business

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31. 1A FLETCHER, *supra* note 15, § 91.

32. *Id.* §§ 102, 118. Among the corporations specifically provided for in the 1994 Utah Code are: (1) nonprofit corporations, UTAH CODE ANN. § 16-6-21 (Supp. 1994); (2) credit unions, *id.* § 7-9-5; (3) savings and loans, *id.* § 7-7-21; (4) insurance companies, *id.* tit. 31A; (5) public utilities, *id.* tit. 54; (6) railroads, *id.* tit. 56; and (7) professional corporations, *id.* §§ 16-11-2, -5.

33. UTAH CONST. art. XII, § 20.

34. 1A FLETCHER, *supra* note 15, § 93.

35. *Id.* § 91.

applications. Consequently, it may be advisable to set forth a specific purpose clause encompassing the primary intended purpose of the business followed by a residual general clause providing for "any lawful purpose or purposes."

#### D. Purpose versus power clauses

Purpose and power clauses differ fundamentally. Whereas "purpose" clauses are intended to set forth the nature of the business, "power" clauses indicate the manner in which the corporation may fulfill its purposes. The Utah Code sets forth broad provisions regarding the general powers of a Utah business corporation, including the power "to conduct its business, locate offices, and exercise the powers granted by this chapter within or without this state."<sup>36</sup> The Utah Code indicates that it is not necessary to specify any of the enumerated powers in the articles of incorporation.

#### E. Ultra vires

"A corporation may exercise only those powers which are granted to it by law, by its charters or articles of incorporation, and by any bylaws made pursuant to the laws or charter."<sup>37</sup> Acts beyond the scope of the powers so granted are ultra vires.<sup>38</sup> Traditionally, any act deemed to be ultra vires was illegal and void. However, the doctrine of ultra vires is less significant than it once was.<sup>39</sup> With the acceptance of general purpose clauses and broad corporate powers, there remains little scope for ultra vires activity,<sup>40</sup> and under the modern approach an ultra vires act, if not a public wrong, is generally not considered to be illegal.<sup>41</sup> Despite the decline of the doctrine, practitioners should be aware of its existence when drafting the purpose clause of the articles of incorporation.

Although section 16-10a-303 of the Utah Code abolishes the doctrine of ultra vires for most purposes, it allows for it to be asserted in:

- (1) shareholder injunction proceedings against corporate actions,
- (2) actions by the corporation or those suing in its behalf against its personnel, or

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36. UTAH CODE ANN. § 16-10a-302(10) (Supp. 1994).

37. FLETCHER, *supra* note 15, § 3399.

38. *Id.*

39. H. HENN & J. ALEXANDER, LAWS OF CORPORATIONS AND OTHER BUSINESS ENTERPRISES § 74 (3d ed. 1983).

40. *Id.*

41. *Id.*

- (3) proceedings by the state to dissolve or enjoin the corporation.<sup>42</sup>

6. *Should the state of incorporation be one other than Utah?*

A. *Entities that plan to do business in Utah*

Generally, if a small corporation will do business exclusively in one state, the presumption is that it should incorporate in that state. The most apparent advantage is the ease of incorporating in the state compared to incorporating out of the state.

Incorporating outside the state in which one plans to do business invites redundancy. To do business in Utah, all foreign corporations are required to register for admission. Many of the admission requirements for foreign corporations are the same as the registration requirements for domestic corporations.<sup>43</sup> With the exception of certain laws governing internal affairs, foreign corporations are subject to the laws applicable to businesses incorporated in Utah.<sup>44</sup> Incorporating in another jurisdiction may also increase taxes. A minimum annual franchise tax will probably be assessed by the state of incorporation. Finally, a corporation may need to maintain a registered agent in its state of incorporation, regardless of whether it engages in business in that state.

Concerns about securities laws also favor incorporating in the state where one will do business. For instance, in order to qualify for the intrastate sales securities law exemption under Securities and Exchange Commission ("SEC") Rule 147,<sup>45</sup> incorporation in the state of business is required.

Finally, one should consider amenability of process. A corporation is always subject to *in personam* jurisdiction in the state in which it incorporates and in any state in which it qualifies as a foreign corporation.<sup>46</sup> Thus, incorporation in a jurisdiction where a corporation does

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42. UTAH CODE ANN. § 16-10a-303(2) (Supp. 1994).

43. Compare *id.* § 16-10a-1503 with § 16-10a-202 (dealing with foreign and domestic corporations). Under § 16-10a-1503(1)(h), a foreign corporation must furnish any "additional information the division may determine is necessary or appropriate to determine whether the application for authority to transact business should be filed." *Id.* § 16-10a-1503(1)(h).

44. *Id.* § 16-10a-1505.

45. See *infra* note 238 and accompanying text.

46. Service of process on a registered foreign corporation in Utah is governed by § 16-10a-1511 of the Utah Code, which provides that service is to be made on the foreign corporation's registered agent or, where the foreign corporation fails to appoint or maintain a registered agent or where the registered agent cannot be served using reasonable diligence, the service may be made by registered or certified mail (return receipt requested) addressed to the corporation's principal office. UTAH CODE ANN. § 16-10a-1511 (Supp. 1994).

According to the United States Supreme Court, even unqualified foreign corporations are subject to the laws of jurisdictions in which they are doing business. See *World Wide*

not otherwise have minimum contacts subjects the corporation to personal jurisdiction in that state. Being forced into litigation in a state where a corporation has no connection other than incorporation can be inconvenient, expensive, and could pose substantial difficulties.

Despite the presumption that a corporation doing business almost exclusively in Utah should incorporate in Utah, exceptions exist.<sup>47</sup> The principal consideration for incorporating in another state is that the other state might have regulations, statutes, or case law that are more favorable to the corporation. Subject to certain constitutional limitations, a domestic corporation is under the legislative jurisdiction of its state of incorporation. Occasionally, regulations of a certain state may be so disadvantageous (or regulations of another state may be so advantageous) as to warrant incorporating in another state. Among those things to be considered are the following: the comparative taxes and fees; the comparative cost of running the business in separate states; the possibility of director and shareholder liability for wrongful acts; the various shareholder's rights, such as access to records and the right to challenge corporate acts; legislative and judicial attitudes toward corporate matters; and the flexibility of remedies given to shareholders of closely-held corporations.<sup>48</sup>

Some states have liberal requirements for the number of officers or directors, while others have special statutes waiving many of the corporate formalities or a better-developed body of corporate law for closely-held corporations. Utah law does not provide for special corporate law treatment of small corporations, although it recognizes and has special provisions for professional corporations.<sup>49</sup>

### *B. Entities involved in multi-state activities*

In choosing the state of incorporation for a business which conducts business in more than one state, the general practice is to incorporate in

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Volkswagen v. Woodson, 444 U.S. 286 (1980); Hanson v. Denckla, 357 U.S. 235 (1958); International Shoe Co. v. Washington, 326 U.S. 310 (1945). All that is required is that the corporation have sufficient minimum contacts. *World Wide Volkswagen*, 444 U.S. at 297. (defining minimum contact as "some act by which the defendant [corporation] purposely avails itself of conducting activities within the forum state, thus involving the benefits and protection of its law."). In Utah, if a corporation is doing business in the state but is not registered as a foreign corporation, service is to be made just as if the corporation was registered, but no registered agent was maintained. *Prudential Fed. Sav. & Loan Ass'n v. William L. Pereira & Assocs.*, 401 P.2d 439 (Utah 1965).

47. See, e.g., 3 ZOLMAN CAVITCH, BUSINESS ORGANIZATIONS WITH TAX PLANNING § 1.02[2] (1994).

48. See RICHARD E. DEER, THE LAWYER'S BASIC CORPORATE PRACTICE MANUAL § 3.01 (3d ed. 1984); 1 O'NEAL & THOMPSON, *supra* note 1, § 2.11.

49. UTAH CODE ANN. §§ 16-11-1 to -15 (Supp. 1994).

the state in which the principal business will be conducted, unless (1) it is intended that the principal offices will be out of state, (2) the director meetings will be held out of state, or (3) the law of that state is somehow inadequate.<sup>50</sup> Most state regulations, including taxation and amenability to suit, will apply in all states in which the corporation does business, regardless of the state of incorporation.<sup>51</sup> Because of this, ease and simplicity suggest incorporating in the state where the corporation's principal place of business and primary offices are located.

However, this general rule should not be followed if the state where the principal place of business is located has certain unfavorable regulations that may be avoided by incorporating in a different state. Further, before the final decision regarding the state of incorporation is made, any non-statutory factors that could impact the corporation should be examined.<sup>52</sup>

### C. *Sanctions for non-compliance with administrative requirements*

Clients may wonder what risks are run by not being properly registered. Different jurisdictions impose various sanctions for failing to qualify as required. Typical sanctions include prohibiting the unqualified corporation from suing either generally or on contracts made within the jurisdiction; imposing fines against the corporation and corporate personnel involved (including possible imprisonment); imposing personal liability on the directors, officers, or agents involved; disabling the corporation from defending litigation or pleading statute of limitations; imposing injunctions; imposing regulatory features; and imposing reciprocal penalties.<sup>53</sup>

Utah withholds the right to sue in any state court until the corporation obtains an appropriate certificate of registration.<sup>54</sup> Utah also

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50. See, e.g., 3 CAVITCH, *supra* note 47, § 61.02[2]; DEER, *supra* note 48, § 3.01.

51. See *Mobil Oil Corp. v. Commissioner of Taxes*, 445 U.S. 425 (1980) (holding that where a foreign corporation does business in Utah and another state, the corporation's income is taxed in Utah according to an apportionment formula which is found in R865-08F of the Administrative Rules of the Utah State Tax Commission).

52. For example, some governments limit the awarding of contracts to domestic corporations. This presents problems in situations where a foreign corporation hopes to perform services or sell goods to local or state governments. In instances where these types of restrictions are found in more than one state in which the corporation hopes to do business, it may be preferable to establish more than one corporation and incorporate in more than one state.

53. HENN & ALEXANDER, *supra* note 39, § 101.

54. UTAH CODE ANN. § 16-10a-1502(1)-(3) (Supp. 1994). However, an action may be brought after the corporation has obtained the certificate, even though the action upon which the suit is brought took place before the acquisition of the certificate. *California Land & Constr. Co. v. Halloran*, 17 P.2d 209 (Utah 1932).

imposes fines on both the corporation and its officers and agents, and requires the courts to enjoin the foreign corporation from transacting further business until the corporation has met all the registration requirements and paid its civil penalties.<sup>55</sup> Nonetheless, section 16-10a-1502(b) of the Utah Code provides that "the failure of a foreign corporation to have authority to transact business in this state does not impair the validity of its corporate acts, nor does the failure prevent the corporation from defending any proceeding in this state." Courts have interpreted the predecessor of section 16-10a-1502(b) to allow non-complying foreign corporations to plead the statute of limitations.<sup>56</sup> This holding will most likely be valid under the current statute.

7. *What quorum requirements should apply for shareholder meetings or director meetings?*

A. *Generally*

A quorum is some type of majority of the group in question, usually shareholders or directors. It is the number of members required to transact business on behalf of the group as a whole. In order for a group of shareholders or directors to be entitled to act as a whole, a quorum must be present. In Utah, only minimum quorum requirements are set forth in the code. However, greater quorum requirements may be set forth in the articles of incorporation or bylaws.

B. *Shareholder quorum*

Section 16-10a-725 of the Utah Code specifies the minimum quorum requirements for conducting business at a shareholder meeting. This section requires that a majority of shareholders be entitled to vote whether in person or proxy. Any vote carrying a majority of those shares that are present and are entitled to vote on the subject matter shall be an act of the shareholders.<sup>57</sup>

C. *Board of director quorum*

Section 16-10a-824 of the Utah Code requires that a quorum of the board of directors have a majority of the number of directors fixed by the bylaws, or a majority of the number of directors existing before the meeting begins if the bylaws allow a variable size of the board. If the

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55. UTAH CODE ANN. § 16-10a-1502(4)-(5) (Supp. 1994).

56. *Clawson v. Boston Acme Mines Dev. Co.*, 269 P. 147 (Utah 1928) (interpreting UTAH CODE ANN. §16-10-120, which was repealed in 1992).

57. UTAH CODE ANN. § 16-10a-725 (Supp. 1994).

bylaws do not set the number of directors, then a majority of the number stated in the articles of incorporation is required for a quorum.<sup>58</sup>

While a basic majority of directors is the minimum required by statute, instability in the board could occur if the passing of resolutions is too easily accomplished. If stability is desired, quorum requirements should be raised. Of course, because a quorum would then be harder to assemble, the board might be restricted in its ability to act in unusual or emergency situations.

Liability of board members should also be considered. Minority members are charged with knowledge and bound by the acts of the majority. In order to reduce the liability of minority board members, higher quorum requirements can be included in the articles or bylaws.

8. *What percent of the voting stock is required to amend the articles or other provisions?*

A. *Generally*

The power to amend the articles of incorporation is important since no provision of the articles of incorporation is any more secure or flexible than the power to amend the articles of incorporation. A few simple, technical amendments to the articles of incorporation, such as changing names and addresses of initial directors or slight alterations to the corporate name, can be accomplished by the board of directors without shareholder approval.<sup>59</sup> Otherwise, a majority vote of the shareholders must ratify amendments to the articles.<sup>60</sup> This statutory straight-voting requirement for amending the articles of incorporation is only a minimum requirement. If the incorporators wish to make the articles more difficult to amend, they may include tougher amendment requirements in the original articles of incorporation.

B. *Amendments affecting specific shareholder classes*

Section 16-10a-1004 allows those who own shares of a specific class of stock to vote as a separate voting group if the proposed amendment to the articles would alter the rights of that class in specific ways, such as changing the number of shares in the class, recharacterizing the shares into shares of another class of stock, or altering the rights of the class in relation to other classes of stock. If such an amendment is attempted, the holders of outstanding shares of the class will be entitled to vote as a

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58. *Id.* § 16-10a-824.

59. *Id.* § 16-10a-1002.

60. *Id.* § 16-10a-1003(5).



class whether or not the articles of incorporation provide for it. This protects any class of stock from being detrimentally changed by a vote of the majority of other shareholders.

In summary, before any general change in the articles of incorporation can be made, at least a majority of the shareholders must approve it. Before any specific change can be made affecting any certain class, that class may vote on the change as a class.

## II. SELECTION AND DUTIES OF DIRECTORS AND OFFICERS

### 9. *What are the names and addresses of the initial directors?*

A director is a person appointed or elected according to the law and authorized to manage the business affairs of a corporation. All of the directors collectively form the board of directors under whose authority "[a]ll corporate powers shall be exercised."<sup>61</sup>

The Utah Code gives businesses much discretion as to who may serve on the board. Directors need not be residents of Utah.<sup>62</sup> The articles of incorporation or the bylaws may prescribe other qualifications for directors or limitations on who can become a director.

Directors may or may not be shareholders. To keep management control in the hands of a small number of shareholders, those shareholders can be elected as directors. However, outside directors often provide additional expertise and fresh points of view.

The corporation may not have less than three directors;<sup>63</sup> however, before the shares are issued, the corporation may have a minimum of one director. Also, the number of directors may be increased or decreased from time to time by amendment to the bylaws. After the shares are issued, if there are fewer than three shareholders entitled to vote for the election of directors, the corporation may have a number of directors equal to or greater than the number of voting shareholders.<sup>64</sup>

The name and address of each director and officer of the corporation must be included in the annual report made to the Division of Corporations and Commercial Code.<sup>65</sup> Various other sections of the Utah Code govern directors of corporations.<sup>66</sup>

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61. *Id.* § 16-10a-801(2). This includes the authority to set the directors' compensation unless otherwise provided in the articles of incorporation. *Id.* § 10-10a-811.

62. *Id.* § 16-10a-802.

63. *Id.* § 16-10(a)-803(1)(a).

64. *Id.* § 16-10a-803(1)(b)(ii).

65. *Id.* § 16-10a-1607.

66. *See id.* § 16-10a-810 (Vacancies on board of directors); *id.* §§ 16-10a-808, -809 (removal of directors); *id.* § 16-10a-824 (quorum of directors); *id.* § 16-10a-825 (designation of committees by board); *id.* § 16-10a-820 (director meetings); *id.* § 16-10a-850 (conflicting

Regular director meetings may be held without notice as prescribed by the bylaws. The directors must receive notice regarding special meetings as prescribed by the bylaws. Unless stated differently in the bylaws, special meetings must be preceded by at least a two-day notice.<sup>67</sup>

*10. What are the names and addresses of the initial officers?*

Generally, the officers of a corporation shall be designated in the corporate bylaws or by the board of directors according to the bylaws.<sup>68</sup> Any person agreeing to become an officer of a corporation should be made aware of the responsibilities and duties that accompany the particular office. The same person may hold two or more offices.<sup>69</sup> The names and addresses of the officers must be kept at the corporation's principle place of business<sup>70</sup> and reported annually to the Division of Corporations and Commercial Code.<sup>71</sup>

The Utah Code imposes statutory restrictions on a corporation with regard to the structure of its body of officers: first, an officer must be appointed to take and maintain minutes at the meetings of the board of directors;<sup>72</sup> second, an officer must be selected to keep certain corporate records required by statute.<sup>73</sup> The board of directors determines who will manage and what their duties will be, but the statute does not require that a president, treasurer, or any other officer holding a specific title be appointed. The Utah Code authorizes corporations to elect or appoint officers, define their duties, and fix their compensation. These duties can be defined in the bylaws or may be determined by a resolution of the board of directors.<sup>74</sup>

Each officer has authority to perform the duties set forth in the bylaws to the extent that his or her actions remain consistent with such bylaws.<sup>75</sup> The duties of Utah corporate officers are not restricted by the Utah Code; rather, they can be structured in any way consistent with the bylaws of the corporation and the decisions of the board of directors.<sup>76</sup>

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interest transactions); *id.* § 16-10a-841 (liability of directors; limitations on personal liability of directors).

67. *Id.* § 16-10a-822(2).

68. *Id.* § 16-10a-830.

69. *Id.*

70. *Id.* § 16-10a-1601(5)(e).

71. *Id.* § 16-10a-1607.

72. *Id.* § 16-10a-830(3).

73. *Id.*

74. *Id.* § 16-10a-831.

75. *Id.*

76. *Id.*

This represents a significant change from the former Utah Business Corporation Act,<sup>77</sup> which outlined specific duties for certain officers.

However, in performing their duties, officers should remember that they owe a fiduciary duty to the corporation and its shareholders by virtue of their positions.<sup>78</sup> The Utah Code imposes upon an officer duties to act in good faith, with ordinary prudence, and in the best interests of the corporation.<sup>79</sup>

The Utah Code occasionally specifies in what situation an officer must or may act. For example, if stock certificates are used they must be signed by two officers.<sup>80</sup> Officers may authorize and approve issuance of shares if they are granted such authority by the board of directors;<sup>81</sup> they may also receive proxy votes or tabulate shareholder votes.<sup>82</sup> Other than this, very little guidance is given governing the officers' duties.

Generally, any officer may be removed by the board of directors with or without cause,<sup>83</sup> but such removal must be without prejudice to any contract rights.<sup>84</sup> Consistent with the discretion the Code gives to corporations to regulate the body of officers, the bylaws may state how officers are to be removed.<sup>85</sup>

### III. RIGHTS AND DUTIES OF SHAREHOLDERS

#### 11. *What are the names and addresses of the initial shareholders?*

A *shareholder* is defined as "the person in whose name shares are registered in the records of a corporation."<sup>86</sup> Thus, in order to perfect any rights or privileges as a shareholder, a person must be properly recorded as such in the records of the corporation. The shares of the corporation may be represented by certificates, but this is not required. If issued, a certificate must state on its face the name of the person to whom it is issued, the name of the corporation, and the number of shares

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77. *Id.* tit. 16, part 10 (repealed in 1992).

78. *See generally* 3 FLETCHER, *supra* note 15, § 838.

79. UTAH CODE ANN. § 16-10a-840(1) (Supp. 1994).

80. *Id.* § 16-10a-625(4)(a).

81. *Id.* § 16-10a-621(6).

82. *Id.* §§ 16-10a-722(6), -724.

83. *Id.* § 16-10a-832(4).

84. However, being elected an agent or an officer does not create any contract rights. *Id.* § 16-10a-833.

85. If the bylaws fail to discuss removal of officers, however, officers may be removed by the board of directors with or without cause. *Id.* § 16-10a-832(4).

86. *Id.* § 16-10a-102(33).

of each class of stock.<sup>87</sup> Even if no certificate is issued, however, the corporation must still send a written confirmation to the stockholder.

Notice of the annual shareholder meeting must be delivered by mail or in person to each shareholder of record entitled to vote at such meetings. The notice should include the place, day and hour of the meeting and be delivered not fewer than ten days nor more than sixty days before the date of the meeting.<sup>88</sup> The date for determining which persons are deemed shareholders for purposes of a meeting may not be more than seventy days before the meeting.<sup>89</sup>

Shareholder names and addresses should be listed in a stock transfer book. This book provides the means to determine who is entitled to notice of shareholder meetings, who may vote at such a meeting, and who is entitled to receive payment of any dividend or distribution.

The corporation must maintain a complete list of the shareholders entitled to vote, arranged first by class, then by alphabetical order, with each shareholder's address and the number of shares of each class held by that shareholder.<sup>90</sup> This information must be kept open for inspection for at least ten days prior to and throughout shareholder meetings. The list can also be used to determine whether a quorum of shares entitled to vote is present at a meeting.<sup>91</sup>

#### *12. What is the date and location of the annual shareholder meetings?*

Pursuant to section 16-10a-701 of the Utah Code, a corporation must hold at least one meeting annually for its shareholders. The time of this meeting shall be stated or fixed in accordance with the corporation's bylaws.<sup>92</sup> Utah law allows these meetings to be held out of state if so established in the bylaws. If no meeting location is established in the bylaws, the meeting must be held at the corporation's principal office. However, failure to hold the annual meeting at the time or location indicated in the bylaws will not affect the validity of any action taken therein.<sup>93</sup> Annual meetings are often held in April or May, allowing time after the calendar year ends for financial audits and annual reports to be prepared for the meetings.<sup>94</sup>

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87. *Id.* § 16-10a-625.

88. *Id.* § 16-10a-705(1).

89. *Id.* § 16-10a-707(3).

90. *Id.* § 16-10a-720(1).

91. *Id.* §§ 16-10a-720(1), 1601(3).

92. *Id.* § 16-10a-701(1).

93. *Id.* § 16-10a-701(3).

94. HENN & ALEXANDER, *supra* note 39, § 191.

The principal purpose of the annual shareholder meeting is to elect directors. Special meetings can be held at other times for appropriate purposes if adequate notice is extended pursuant to section 705(3)-(5).<sup>95</sup> Special meetings may be called by the corporation's board of directors, persons so authorized in the corporation's bylaws, or by a percentage of the shareholders affected by a given issue pursuant to the provisions of section 702(1)(b). The topic of a special meeting is restricted to those matters described in the meeting notice.<sup>96</sup> Section 702 of the Utah Code sets forth the particular requirements of special meetings.

Written notice of the place, day and hour of the meeting must be sent to shareholders of record.<sup>97</sup> There are certain conditions in which notice need not be sent to a shareholder, such as when two prior attempts to contact the shareholder at his or her address of record were returned undelivered.<sup>98</sup>

### 13. *Will the shareholders have preemptive rights?*

After incorporation is complete, a corporation may issue additional stock.<sup>99</sup> When this new stock is issued, existing shareholder interests can be impaired through a loss of value and decrease in voting power unless an opportunity to prevent this dilution is given to the existing shareholders. Shareholder rights to purchase a proportional amount of new shares are called "preemptive rights." Preemptive rights allow shareholders to maintain their proportionate equity interest in a corporation.<sup>100</sup>

#### A. *Mandatory Election of Preemptive rights*

Prior to July 1, 1992, when the "opt out" provisions of the prior statute were revised, shareholders were deemed to possess preemptive rights unless denied or limited in the articles of incorporation.<sup>101</sup> However, under the Revised Business Corporation Act Section 16-10a-630, which is an "opt in" statute, shareholders are now deemed *not* to

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95. *Id.* § 16-10a-705(3)-(5). See also, 18A AM. JUR. 2D *Corporations* § 949 (1985).

96. UTAH CODE ANN. § 16-10a-702 (Supp. 1994).

97. *Id.* § 16-10a-705.

98. *Id.* § 16-10a-705(5)(a).

99. For preemption purposes, the Utah Code defines the term "shares" to include "any security convertible into or carrying a right to subscribe for or acquire shares." *Id.* § 16-10a-630(3).

100. *Id.* § 16-10a-630(1).

101. *Id.* § 16-10a-1704(3).

have preemptive rights unless expressly provided in the articles of incorporation.<sup>102</sup>

The 1992 change in the law cannot deny preemptive rights to a shareholder who, prior to July 1, 1992, was entitled to preemptive rights under the "opt out" provisions.<sup>103</sup> In such circumstances, the articles of incorporation shall be treated as if they included the statement "the corporation elects to have preemptive rights," until a resolution providing otherwise is adopted.<sup>104</sup>

Preemptive rights can be added to or removed from the articles of incorporation, and existing rights may be modified.<sup>105</sup> The Utah Code requires that any amendment that alters or abolishes preemptive rights be proposed by the board of directors and approved by at least a majority of the shareholder votes.<sup>106</sup> Thus, minority preemptive interests are subject to removal or dilution unless the articles require some type of super-majority shareholder vote to approve any modification of preemptive rights. In situations where minority interests are at risk, the articles of incorporation should include a provision requiring a super-majority vote in order to amend preemptive rights.

### B. *Language Required*

A statement in the articles of incorporation that "the corporation elects to have preemptive rights," or similar words are sufficient to insure the limited preemptive rights outlined by the statute.<sup>107</sup> Nevertheless, statutory preemptive rights have many exceptions.<sup>108</sup> Thus, it would be prudent in some situations to limit or abandon certain statutory exceptions through the articles of incorporation.

### C. *Notice to shareholders*

Subject to any uniform terms and conditions prescribed by the board of directors, existing shareholders must be given a fair and reasonable opportunity to acquire a number of the shares proposed to be issued in an amount proportionate to their percentage ownership of the corporation's outstanding shares.<sup>109</sup> Furthermore, the articles of incorporation

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102. *Id.* § 16-10a-630. This statutory change reflects the fact that while preemptive rights may be important in small or closely-held corporations, larger corporations often find them irrelevant, burdensome, or difficult to enforce. O'NEAL & THOMPSON, *supra* note 1, § 3.39.

103. UTAH CODE ANN. § 16-10a-1704(3) (Supp. 1994).

104. *Id.*

105. *Id.* § 16-10a-1003.

106. *Id.*

107. *Id.* § 16-10a-630(2).

108. *Id.*

109. *Id.* § 16-10a-630(2)(a).

should establish specific notice requirements and define the "reasonable time" in which shareholders must exercise their preemptive rights. The articles should also state that a shareholder's failure to assert his or her right within the prescribed time constitutes a waiver. The prescribed time should be reasonable, but not so long as to inhibit corporate activities or unduly burden the corporation's ability to raise needed capital in a timely manner.

Shares not acquired by shareholders under their preemptive rights may be issued to any person for one year after the date the shareholder releases his or her preemptive rights. The consideration paid to the corporation may not be lower than the consideration set for the exercise of preemptive rights.<sup>110</sup> Any offer made by the corporation for less consideration or made after the expiration of the one year period is again subject to shareholder preemptive rights.<sup>111</sup>

#### *D. Exceptions to Preemptive Rights*

There are no statutory preemptive rights with respect to (1) shares issued as compensation for services to directors, officers, agents, or employees of the corporation, its subsidiaries, or affiliates; (2) shares issued to satisfy conversion or option rights created to provide compensation for services of the above individuals; (3) shares issued within six months of the effective date of incorporation; or (4) shares sold for consideration other than cash.<sup>112</sup> Preemptive rights are significantly diluted under these statutory exceptions. Consequently, in certain situations directors may wish to protect shareholder preemptive rights by drafting articles of incorporation that expressly eliminate any or all of these exceptions.

#### *E. Multiple classes of stock*

Questions regarding preemptive rights can become complicated if a company issues multiple classes of stock. Although the Code has attempted to address such problems,<sup>113</sup> extra precautions should be taken during incorporation to examine and clarify the operation of all preemptive rights if a company intends to issue various classes of stock.

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110. *Id.* § 16-10a-630(2)(f).

111. *Id.*

112. *Id.* § 16-10a-630(2)(c).

113. For example, holders of shares without voting rights have no preemptive rights. Holders of shares with voting rights but without preferential rights to distribution have no preemptive rights to shares without general voting rights, unless such newly issued shares are convertible to shares with general voting rights or without preferential rights. *Id.* § 16-10a-630(2)(e).

### F. Preemptive interests in stock redemptions

The Utah Code makes no reference to preemptive interests during stock redemptions. In the absence of any provision to the contrary, majority shareholders could drain capital from a company by selectively redeeming the stock of specific shareholders. To avoid this unequal treatment of shareholders, when drafting articles of incorporation one should consider adding a clause allowing all shareholders to participate proportionally in any stock redemption. This "reverse preemptive right" would protect minority interests.<sup>114</sup>

#### 14. Will voting for directors be cumulative or straight?

Section 16-10a-721(1) of the Utah Code provides that "each [whole] outstanding share, regardless of class, is entitled to one vote . . . on each matter voted on at a shareholder meeting,"<sup>115</sup> unless (1) the articles of incorporation provide otherwise; (2) the shares have been redeemed; or (3) the shares are owned by a second corporation and the first corporation owns a majority of the shares entitled to vote for the directors of the second corporation.<sup>116</sup> An exception to this rule allows for "cumulative voting" during the election of the board of directors if the articles of incorporation so provide.<sup>117</sup>

Cumulative voting grants each shareholder the number of votes equivalent to the number of shares held, multiplied by the number of directors to be elected.<sup>118</sup> A shareholder may "cumulate" votes by casting them all in favor of a single candidate or distributing them among the candidates in any combination desired. For example, when cumulative voting is allowed, a holder of one-third of the shares plus one can elect one of two directors, and a holder of one-fourth of the shares plus one can elect one of three directors.

Cumulative voting protects the interests of minority shareholders by ensuring them proportionate representation on the board of directors.<sup>119</sup> In closely-held businesses, minority representation on the Board promotes proper treatment of those minority interests that hold a percentage of stock sufficient to elect a single director. To adequately protect minority interests, however, the number of directors needs to be in proportion to

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114. O'NEAL & THOMPSON, *supra* note 1, § 3.34.

115. UTAH CODE ANN. § 16-10a-721(1) (Supp. 1994).

116. *Id.*

117. *Id.* § 16-10a-728.

118. See Richard S. Dalebout, *Cumulative Voting for Corporation Directors: Majority Shareholders in the Role of a Fox Guarding a Hen House*, 1989 B.Y.U. L. REV. 1199.

119. See *Summary of Utah Corporation Law*, B.Y.U. J. LEGAL STUD., § 12.14 (1982).



the number of shares outstanding. The number of shares and directors should also be calculated so as to avoid voting deadlocks.<sup>120</sup> Corporate documents should be drafted to protect against circumvention of cumulative voting provisions. Circumvention might occur in a number of ways:<sup>121</sup>

- (1) If the articles of incorporation allow for liberal amendment, a cumulative voting provision may be altered or deleted. Pursuant to Utah Code section 16-10a-1003(5)(b)(4), amending cumulative voting rights requires only a majority vote of the shareholders unless the articles of incorporation require a higher percentage.<sup>122</sup>
- (2) If the number of directors can be easily increased or decreased, the desired representation may be upset.<sup>123</sup> Minority shares sufficient to elect one director when cumulated may not be able to do so if the number of directors is decreased. Pursuant to Utah Code section 16-10a-803, the number of directors can be increased or decreased (but not below three) by amending the bylaws. Such bylaw provisions can be amended by the board of directors, unless prevented by the articles of incorporation or other provisions of the bylaws.<sup>124</sup> Thus, the directors can cause the number of directors to fluctuate by amending the bylaws, thereby negating cumulative voting, unless the articles of incorporation limit the board's power.
- (3) In the absence of preemptive rights, a subsequent issuance of stock by the corporation may dilute the voting power of minority shareholders.
- (4) The proportion of directors to minority shareholders may be altered to the point of decreasing minority voting power.
- (5) Staggered voting or classification of directors may void the effect of cumulative voting.<sup>125</sup> For example, if only one director were elected each year, the number of shareholder votes in each election would be limited to the number of shares held. Thus, as in straight voting, the majority interests would dominate in each separate election.
- (6) Non-secret or non-simultaneous voting may cause minority shareholders to manipulate their vote thereby obtaining dis-

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120. See Lewis R. Mills, *Mathematics of Cumulative Voting*, 28 DUKE L.J. 28, 38 (1968).

121. See Dalebout, *supra* note 118, at 1205-24.

122. See discussion *supra* question 13.

123. See Dalebout, *supra* note 118, at 1212.

124. UTAH CODE ANN. § 16-10a-1020 (Supp. 1994).

125. See Dalebout, *supra* note 118, at 1214-18.

proportionately increased representation. For example, if minority interests were to learn (a) how majority interests are going to vote, and (b) that majority voting will not be proportionate to votes available to majority shareholders, minority shareholders could spread their votes sufficiently thin so as to obtain disproportionately increased representation.

15. *Will the shareholders enter into any voting agreements?*

In a voting agreement, shareholders enter into a contract or agreement to combine their voting power in a certain way. The most common object of voting agreements is the election of directors, but such agreements are available for any corporate matter for which a vote of the shareholders is necessary or appropriate. Voting agreements are distinguishable from voting trusts because the shareholder retains title to and possession of the shares.<sup>126</sup> The shareholder, not a trustee, is entitled to vote, although the shareholder's choice may be restricted by the voting agreement.<sup>127</sup> Both the Model Business Corporation Act<sup>128</sup> and the Revised Model Business Corporation Act<sup>129</sup> allow for shareholder voting agreements. A number of states, including Utah,<sup>130</sup> have recently enacted similar provisions.

As a general rule, voting agreements are presumed to be valid in all jurisdictions<sup>131</sup> absent fraud, oppression of minority shareholders, or other illegal method or object involved.<sup>132</sup> Voting agreements are permissible because shareholders are under no fiduciary duties to act in the best interest of the corporation. They may act for selfish reasons and may do collectively what they could do individually.<sup>133</sup>

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126. 1 O'NEAL & THOMPSON, *supra* note 1, § 5.18.

127. UTAH CODE ANN. § 16-10a-731 (Supp. 1994).

128. Section 34 provides that: "Agreements among shareholders regarding the voting of their shares shall be valid and enforceable in accordance with their terms. Such agreements shall not be subject to the provisions of this section regarding voting trust." 1 MODEL BUSINESS CORP. ACT ANN. § 34 (2d ed. 1971).

129. Section 7.31 reads as follows:

Voting Agreements

(a) Two or more shareholders may provide for the manner in which they will vote their shares by signing an agreement for that purpose. A voting agreement created under this section is not subject to the provisions of [section] 7.30 [dealing with voting trusts].

(b) A voting agreement created under this section is specifically enforceable.

1 MODEL BUSINESS CORP. ACT ANN. § 7.31 (3d ed., 1993).

130. UTAH CODE ANN. § 16-10a-731 (Supp. 1994).

131. HENN & ALEXANDER, *supra* note 39, § 267.

132. *Id.* (citing *Manson v. Curtis*, 119 N.E. 559, 561 (1918)).

133. *Id.* § 198.

A voting agreement is valid in Utah even though it:

- (1) eliminates the board of directors or restricts the discretion or powers of the board of directors;
- (2) governs the authorization or making of distributions whether or not in proportion to ownership of shares, subject to the limitations in 16-10a-640;
- (3) establishes who shall be directors or officers of the corporation, or their terms of office or manner of selection or removal;
- (4) governs, generally or specifically, the exercise or division of voting power by, between, or among the shareholders and directors, including use of weighted voting rights or director proxies;
- (5) establishes the terms and conditions of any agreement for the transfer or use of property or the provision of services between the corporation and any shareholder, director, officer, or employee of the corporation or among any of them;
- (6) transfers to one or more shareholders or other persons all or part of the authority to exercise the corporate powers or to manage the business and affairs of the corporation, including the resolution of any issue about which there exists a deadlock among directors or shareholders;
- (7) requires dissolution of the corporation at the request of one or more of the shareholders or upon the occurrence of a specified event or contingency; or
- (8) otherwise governs the exercise of the corporate powers or the management of the business and affairs of the corporation or the relationship among the shareholders, the directors and the corporation, or among any of them, and is not contrary to public policy.<sup>134</sup>

Furthermore, in Utah the shareholder agreement is valid for ten years unless otherwise stated.<sup>135</sup>

In the event of a breach or a threatened breach of a valid shareholder agreement, the usual remedy is money damages. However, in many cases, money damages may not be adequate. Therefore, the Utah statute permits an agreement to allow for specific performance as an appropriate remedy.<sup>136</sup>

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134. UTAH CODE ANN. § 16-10a-732(1) (Supp. 1994).

135. *Id.* § 16-10a-732(2)(c).

136. *Id.* § 16-10a-731(2).

## IV. TAX AND FINANCIAL ACCOUNTING

16. *Will the taxable year be the calendar year or a fiscal year?*<sup>137</sup>

In order to appropriately determine taxable income,<sup>138</sup> a tax period must be established.<sup>139</sup> The term "taxable year" means the calendar year or fiscal year upon which taxable income is computed.<sup>140</sup> The choice of a taxable year is significant because it may determine the effective rate of tax, the applicability of new legislation, and the timing of tax payment.

Generally, the taxable year should coincide with the annual accounting period. If a taxpayer fails to establish its annual accounting period, it is usually precluded from using a fiscal year and, therefore, is automatically required to report income on a calendar year.<sup>141</sup> If a fiscal year is desired, the accounting period should be "adopted via corporate bylaw, or by a resolution of the stockholders or directors."<sup>142</sup> Once a taxable year is chosen, the consent of the Commissioner of the Internal Revenue is usually required to change it.<sup>143</sup>

The initial year need not cover a full twelve months. Therefore, a corporation may fix its first tax year so as to maximize its use of the lower tax bracket. However, this should not be the sole motivation in choosing the corporate tax year. It is more important that the chosen taxable year fit the general operation of the corporation. Ideally, a corporation should choose a fiscal year end when assets are most liquid and when inventories are low, since this is usually preferred for the financial accounting period.

17. *What is the name of the corporation's bank?*

A bank resolution naming the bank or banks to be used by the corporation should be adopted during the first meeting of the incorporators. Prior to the meeting, a copy of the bank's standard signature card and corporate resolution form should be obtained.<sup>144</sup> The forms can be

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137. See generally, D. Alden Newland & Max E. Klinger, *The Costs of Electing a Fiscal Year Under New Section 444*, 68 J. TAX'N 206 (1988).

138. I.R.C. § 63(a) (1994).

139. *Id.* § 441(a).

140. *Id.* § 7701(a)(23).

141. *Id.* § 441(b)(1).

142. HENRY W. SCHMIDT & RICHARD R. MAGNUSON, JR., BUREAU OF NAT'L AFFAIRS, 56-3d T.M., TAX MANAGEMENT: ACCOUNTING PERIODS A-2 (1993).

143. I.R.C. § 442 (1994); Treas. Reg. § 1.442-1 (as amended in 1987).

144. HENN & ALEXANDER, *supra* note 39, § 135.

completed and signed at the meeting, and a bank account subsequently opened.

The incorporators may wish to require the signature of more than one officer on checks drawn on the corporate account. The bank has a duty to act in accordance with any such requirement set forth by the incorporators, or by other sanctioned arrangement with the bank, including agreements or provisions of the corporate bylaws.<sup>145</sup>

*18. What is the budget projection for the first three years?*

The attorney should request a projected budget covering the first few of years of operation. This budget will assist the practitioner in assessing and meeting the needs of the client.

*A. Choice of entity*

A budget will help the practitioner determine the best type of business entity. The extent of the profits or losses of a business in its early years may indicate that a form of organization other than a C-corporation is more appropriate. For example, if a business is expected to lose money during the first three years of operation, it may be advantageous to conduct the business as an S-corporation so that losses will pass through to the shareholders. The budget may also indicate the need for substantial capital either now or as the business grows. Notes or stock of various types may need to be issued to raise capital.

The budget may also indicate that more than one business unit is preferable. Though using a single business unit generally tends to promote efficiency, certain tax advantages may be available by forming multiple business units.

*B. Capitalization*

Before the corporate charter and other papers can be drafted, the participants must work out the details of their business bargain, deciding how much capital each will contribute and how much is to be obtained from outside sources. In conjunction with this task, they must help determine whether financing should be internal or external and whether it should be in the form of debt or equity. The type of financing chosen also raises questions of thin capitalization and the type of equity to be issued.<sup>146</sup> The projected budget will be of vital importance to the practitioner in answering these types of questions.

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145. *Movie Films, Inc. v. First Sec. Bank*, 447 P.2d 38, 40 (Utah 1968).

146. The practitioner should advise the participants about the characteristics of common and preferred stock and the advantages of § 1244 stock. See *infra* questions 19, 20, and 23.

### C. Other planning issues

Besides helping to resolve the issues mentioned above, the projected budget can assist the practitioner in resolving other planning issues including accounting and inventory methods, benefit plans, and compensation issues.

1. *Accounting method.* Section 448 of the Internal Revenue Code prohibits the use of the cash method of accounting in the case of a C-corporation unless it or any predecessor's average annual gross receipts in the three year period ending with the year in question did not exceed \$5 million.<sup>147</sup> Further, the accounting method must conform with the method by which the taxpayer regularly computes its income in keeping its books and the method of accounting must clearly reflect income.<sup>148</sup> The practitioner should determine whether the cash method of accounting will be available to small businesses, and if so, whether the cash method is the best for the small business.

2. *Inventory method.* In selecting its inventory accounting method, a business must select the method the Secretary prescribes as conforming as much as possible to the best accounting practice in the trade or business and as most clearly reflecting the income.<sup>149</sup> The method adopted generally applies to the entire inventory and, once the election is made, it may not be changed without permission of the Internal Revenue Service. The election should only be made after consulting the projected budget.

3. *Employee benefits.* Corporations have a few advantages over other business forms in the area of employee benefits.<sup>150</sup> Which benefits will be instituted should be discussed with the client after consulting the projected budget.

4. *Compensation.* Numerous compensation issues arise at the formative stages of a corporation, including the reasonableness and timing of compensation, reallocation of income, and so forth. These issues should be analyzed and discussed.

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147. I.R.C. § 448(b)(3) (1994).

148. *Id.* § 446(a)-(b).

149. *Id.* § 471.

150. Any benefit plan arrangements based on stock, such as stock bonus plans, stock option plans, or ESOPs, are available only to corporations. Shareholder-employees of C-corporations may receive tax qualified fringe benefits generally without restriction, but owners of more than 2% of S-corporations and partners are limited with respect to such benefits as employer-provided health care, lodging, and group term life insurance. See generally RIA United States Tax Reporter 13,609.01; Choice of Entity, BNA Tax Management Portfolio No. 700 (comparing legal and tax differences between these business entities).

### 19. Will the corporation make a Subchapter S election?

#### A. Purpose

A "small business corporation," commonly known as an S-corporation, was created by Congress to eliminate some of the differences in tax treatment between small businesses conducted as corporations and small businesses conducted as partnerships.<sup>151</sup> Deciding whether to make an S-corporation election requires an assessment of both the tax and non-tax related advantages.

#### B. Tax advantages

The major tax advantage in making an S-corporation election is avoiding double taxation of corporate dividends. Double taxation is avoided because S-corporation income is "passed-through" to the shareholders, much like a partnership. This allows income to be taxed only at the shareholder level instead of being taxed both at the corporate level when it is earned and at the shareholder level when it is distributed as dividends.<sup>152</sup> Making an S-corporation election will create additional tax savings if the corporate tax rate is higher than the shareholder's tax rate.<sup>153</sup> Losses incurred by an S-corporation are also "passed-through" to the shareholders, but are limited to the amount of each shareholder's adjusted basis in his or her stock and debt owed by the corporation to the shareholder.<sup>154</sup>

Another tax benefit of the S-corporation is its income shifting possibilities. One income shifting possibility occurs because neither the shareholder nor the corporation recognizes gain on contributions of appreciated property;<sup>155</sup> upon sale or other disposition of the property,

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151. Under Utah law, every corporation that elects to be treated as a small business corporation for federal tax purposes is required to file a return every year stating: (1) the gross income and deductions allowable under the I.R.C.; (2) the names and addresses of all shareholders; (3) the number of shares owned by each shareholder; (4) the date of distribution of shares; and (5) any other information required by the tax commission. UTAH CODE ANN. § 59-10-510 (Supp. 1994).

152. I.R.C. § 1366 (1994). However, some S-corporations pay taxes on built-in gains, *id.* § 1374, and excess net passive income, *id.* § 1375.

153. Refer to the tax table to determine whether the tax rate is lower for individuals than for an S-corporation. *Id.* §§ 1, 11.

154. *Id.* § 1366(d).

155. However, if the shareholder is in control of the corporation immediately after the contribution, gain or loss must be recognized by the shareholder. See Avi O. Liveson, *Partnership vs. S-Corporations: A Comparative Analysis in Light of Legislative Developments*, 5 J. PARTNERSHIP TAX'N 142 (1988).

the gain is allocated among the shareholders of the corporation.<sup>156</sup> However, the corporation must recognize gains on a non-liquidating distribution of appreciated property.<sup>157</sup> Additional income shifting is possible through the transfer of stock before the tax year ends because S-corporation income is not allocated to the stock until the end of the year.

### C. *Non-tax advantages*

The major non-tax reason for making an S-corporation election is the advantage of having the limited liability available to corporations while at the same time having the flexibility of being treated like a partnership. Another non-tax advantage is that S-corporation stock is in principle transferrable. This makes an S-corporation more attractive than a partnership because the ownership and/or income is generally easier to transfer through gifts or sales of stock than through gifts or sales of a partnership interest.<sup>158</sup>

### D. *Requirements*

The S-corporation election can be made at any time provided the small business:

- (1) is incorporated in the United States;
- (2) has no more than 35 shareholders;<sup>159</sup>
- (3) has shareholders that are individuals or qualifying trusts;<sup>160</sup>
- (4) has no non-resident alien shareholders;<sup>161</sup> and
- (5) has no more than one class of stock.<sup>162</sup>

To be treated as an S-corporation, an election must be made by unanimous shareholder consent during the preceding taxable year, or during the taxable year on or before the fifteenth of the third month of that taxable year.<sup>163</sup> The S-corporation status is valid until terminated by revocation, failure to meet any one of the "small business corpora-

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156. See I.R.C. § 1366 (1994).

157. See *id.* § 1371(a).

158. For a comparison of the advantage of an S-corporation over a partnership and the benefits from combining the two forms of organization, see Liveson, *supra* note 155; William M. Ruddy, *Combination Can Provide Flexibility of Partnership with S Corporation Advantages*, 18 TAX'N FOR LAW. 186 (1989).

159. I.R.C. § 1361(b)(1)(A) (1994). A husband and wife will be treated as one shareholder. *Id.* § 1361(c)(1).

160. *Id.* § 1361(b)(1)(B). This precludes corporations and most trusts from holding stock in the S-corporation. However, the trusts described in § 1361(c)(2) and a Qualified Subchapter S Trust described in § 1361(d) can be shareholders in an S-corporation.

161. *Id.* § 1351(b)(1)(C).

162. *Id.* § 1361(b)(1)(D). However, differences in voting rights are permitted. *Id.* § 1361(c)(4).

163. *Id.* § 1362(a)-(b).



tion" requirements mentioned above, or when passive investment income exceeds 25% of gross receipts for three straight years in the case of a corporation that has C-corporation earnings and profits from years before it made its S-corporation election.<sup>164</sup>

In the year the election is terminated, the corporation is required to file an S-Corporation short year tax return up to the date of termination and a C-corporation tax return for the period after termination.<sup>165</sup> Once the S-corporation election has been terminated, another election is not permitted for a period of five years.<sup>166</sup> Termination results in future tax treatment identical to that of any other C-corporation.

## V. ISSUANCE OF SECURITIES

### 20. *What will be the number of shares authorized?*

Utah law requires that a corporation's articles of incorporation describe the classes of shares and the number of shares of each class that the corporation is authorized to issue.<sup>167</sup> A corporation may only issue as many shares as are authorized in its articles of incorporation. All corporations must authorize at least one class of shares. If more than one class of shares is authorized, the articles of incorporation must describe a distinguishing designation for each class and the preferences, limitations, and relative rights of the class prior to its issuance.<sup>168</sup> The articles of incorporation may also authorize multiple series of shares in each class. Utah Code sections 16-10a-601 and -602 govern the authorization of corporate shares.

Authorizing more shares than will be issued in the immediate future permits a corporation to quickly raise more capital for expansion of the new business. However, this does not mean that a corporation should always authorize more shares at the outset than it plans to issue right away. The main issue in this determination is one of flexibility. For example, if a new corporation has three owners and they want the corporation to be held by a maximum of three stockholders (i.e., a limit on the number of stockholders), then one way to accomplish this is to restrict flexibility by only authorizing three shares of stock.

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164. *Id.* § 1362(d).

165. *Id.* § 1362(e).

166. *Id.* § 1362(g).

167. UTAH CODE ANN. § 16-10a-601(1) (Supp. 1994). Part 6 of Chapter 10a of the Revised Business Corporation Act addresses "Shares and Distributions" and outlines further corporate requirements and responsibilities with respect to corporate shares.

168. *Id.* § 16-10a-601.

21. *To whom will the shares be issued and for what consideration?*

Utah Code sections 16-10a-603 and -621 govern the issuance of shares of corporate stock. These sections provide that the corporation may issue up to the number of shares of each class or series authorized by the corporation's articles of incorporation. These shares are considered outstanding until they are reacquired, redeemed, converted, or canceled.

The board of directors is the body empowered to issue corporate shares and may do so for consideration consisting of any tangible or intangible property or benefit to the corporation.<sup>169</sup> The terms of any consideration to be received in the future in exchange for corporate shares must be in writing.<sup>170</sup> It is the duty of the board of directors to determine that the consideration received or to be received for the shares to be issued is adequate.<sup>171</sup>

The corporation can place in escrow shares issued in consideration for future services or benefits, or in consideration for a promissory note.<sup>172</sup> The corporation can credit distributions against the shares purchase price until the services are complete or the note becomes due.<sup>173</sup> If such services are not completed or the note is not paid, the escrowed shares and distributions credited may be canceled in whole or part.<sup>174</sup>

22. *Will the stock have par value?*

The Utah Revised Business Corporation Act eliminates any need for par value stock. All references to par value, stated capital, and capital surplus have been deleted from the Utah Code as well as the \$1000 capital start-up requirement. However, directors are required to stipulate an adequate amount of consideration received for shares.<sup>175</sup> Once this amount is determined, all stock is deemed validly issued, fully paid, and nonassessable once such consideration has been paid for the stock.<sup>176</sup> Furthermore, shareholders are personally liable to the corporation or its

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169. *Id.* § 16-10a-621(1).

170. *Id.* § 16-10a-621(2).

171. *Id.* § 16-10a-621(3).

172. *Id.* § 16-10a-621(5). If the shares are to be issued for consideration to be received in the future under contractual agreement or other arrangement, the corporation must place these shares in escrow or otherwise restrict their transfer until receipt of the agreed future consideration. *Id.*

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.* § 16-10a-621(3).

creditors only up to the amount of the consideration deemed adequate by the directors.<sup>177</sup>

23. *Will the stock be subject to transfer restrictions?*

Control of a corporation can be preserved through restrictions on stock transferability imposed by the issuer.<sup>178</sup> Transfer restrictions can, depending on the restriction employed, help existing shareholders retain power to choose future associates, prevent future shifts of control, help provide a market for shareholders' stock, permit the corporation to eliminate a shareholder, discourage shareholders from leaving the corporation, and help the corporation maintain Subchapter S status by permitting transfers only to qualifying shareholders.

Section 16-10a-627(2) of the Utah Code makes a transfer restriction ineffective against subsequent purchasers having no notice of the restriction unless:

- (1) the security is certified and the restriction is noted conspicuously on the front or back of the certificate; or
- (2) the restriction is contained in the information statement required by section 16-10a-626(2).<sup>179</sup>

The Utah Professional Corporation Act<sup>180</sup> governs transfer restrictions on stock of professional corporations,<sup>181</sup> but contains no provision directly governing transfer restrictions of non-professional corporation stock.

Courts construe transfer restrictions narrowly,<sup>182</sup> as public policy disfavors restraint on alienation.<sup>183</sup> However, courts will generally sustain transfer restrictions "that they think are 'reasonable' in light of all the circumstances of the particular case."<sup>184</sup> Section 16-10a-627(e) of the Utah Code gives three situations when transfer restrictions are authorized:

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177. *Id.* § 16-10a-622.

178. See R. FRANKLIN BALOTTI & J.J. FINKELSTEIN, *THE DELAWARE LAW OF CORPORATIONS AND BUSINESS ORGANIZATIONS* §§ 6.6-6.12 (1988).

179. UTAH CODE ANN. § 16-10a-627(2) (Supp. 1994).

180. *Id.* §§ 16-11-1 to -15.

181. *Id.* § 16-11-13.

182. See, e.g., *Riche v. North Ogden Professional Corp.*, 763 P.2d 1210 (Utah Ct. App. 1988), *aff'd*, 784 P.2d 1126 (Utah 1989) (construing restriction on sale of professional corporation stock narrowly under Utah Professional Corporation Act).

183. 1 O'NEAL & THOMPSON, *supra* note 1, § 7.06.

184. *Id.* (providing a comprehensive list of factors courts consider when determining the validity of share transfer restrictions).

- (1) "to maintain the corporation's status when it depends on the number or identity of its shareholders;"<sup>185</sup>
- (2) "to preserve entitlements, benefits, or exemptions under federal, state, or local laws;"<sup>186</sup> and
- (3) "for any other reasonable purpose."<sup>187</sup>

When drafting transfer restrictions, the law on their validity should be studied carefully to determine which restrictions will be upheld. Transfer restrictions should be tailored with precision to meet the particular needs of each corporation; standard forms should be used only as a guideline.

Transfer restrictions can be fashioned in many ways. Under the Utah Code, a transfer restriction may:

- (1) obligate the shareholder first to offer to the corporation or other persons, separately, consecutively, or simultaneously, an opportunity to acquire the restricted shares;
- (2) obligate the corporation or other persons, separately, consecutively, or simultaneously, to acquire the restricted shares;
- (3) require, as a condition to a transfer or registration, that a person or persons, including the corporation or any of its shareholders, approve the transfer or registration, if the requirement is not manifestly unreasonable; or
- (4) prohibit the transfer or the registration of a transfer of the restricted shares to designated persons or classes of persons, if the prohibition is not manifestly unreasonable.<sup>188</sup>

The above description of transfer restrictions is not exhaustive.<sup>189</sup> Variables might include:

- (1) the duration of the restriction, which might be indefinite or limited to a stated term or by the occurrence of a contingency;
- (2) the nature of the consent, if any, to be required;
- (3) whether the consent will be required of the directors, the other shareholders, or of the shareholders as a whole;
- (4) whether the restriction will apply to transfers which operate by law, such as bequests or gifts;
- (5) the type of financing for mandatory "buy-out" type restrictions, which may involve sinking funds, time payments or insurance;
- (6) the valuation of the stock at the time of transfer; and

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185. UTAH CODE ANN. § 16-10a-627(3) (Supp. 1994).

186. *Id.*

187. *Id.*

188. *Id.* § 16-10a-627(4).

189. *Id.* § 16-10a-627(5).

- (7) the rights of parties affected should one party fail to properly comply or conform to the restrictions.<sup>190</sup>

Since the above lists are by no means exhaustive, transfer restrictions present numerous and varied issues which must be carefully considered so as to withstand judicial scrutiny. To determine whether transfer restrictions are properly tailored to meet the stated legal requirements, courts have looked at the following factors:

- (1) corporate size;
- (2) the degree of restraint on the power to alienate one's interest;
- (3) the duration of the restriction;
- (4) the method of determining transfer/option price of shares subject to restraint;
- (5) fairness or unfairness of the procedure used to adopt a restriction;
- (6) the likelihood of its attaining the corporate objectives; and
- (7) the likelihood that the restriction will promote the best interests of the enterprise as a whole.<sup>191</sup>

Tax ramifications may also need to be considered as transfer restrictions may affect income, gift, or estate tax liabilities.<sup>192</sup>

#### 24. *Will the stock be subject to any buy-sell agreements?*

To keep competitors and other potentially unfriendly individuals from participating in the day-to-day operations of the business, the transferability of closely-held corporate shares can be further restricted through buy-sell agreements between the shareholders or between the corporation and the shareholders.<sup>193</sup> Buy-sell agreements may control shares based on the occurrence of common contingencies or "triggering events." Buy-sell agreements may be evidenced in the articles of incorporation, the bylaws, or separate shareholder agreements.<sup>194</sup>

Not all buy-sell restrictions will be valid. Utah law and the Uniform Commercial Code specifically invalidate restrictions on the transfer of securities, even though otherwise lawful, unless:

- (1) the receiver has actual knowledge of the restriction,<sup>195</sup>

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190. See generally 18A AM. JUR. 2D *Corporations* §§ 681-727 (1985); O'NEAL & THOMPSON, *supra* note 1, § 7.

191. See 18A AM. JUR. 2D *Corporations* § 683 (1985).

192. See, e.g., 10 JACOB MERTENS, JR., *MERTENS LAW OF FEDERAL INCOME TAXATION* § 38B.46, 119-22 (1995) (buy-sell agreements resulting in constructive dividend).

193. See Henry J. Lischer, Jr., *Buy-Sell Agreements for Closely-Held Business Interests*, 44 TEX. B.J. 283, 287 (1981) (discussing essential elements of buy-sell agreements).

194. UTAH CODE ANN. § 16-10a-627 (Supp. 1994).

195. The person claiming that the transferee had actual knowledge of the restriction which does not appear on the certificate has the burden of proving the transferee's actual knowledge

- (2) the restrictions are "noted conspicuously on the instrument" if the security is certified,<sup>196</sup> or
- (3) if the security is uncertified, "a notation of the restriction" is contained in the initial transaction statement received by the transferor.<sup>197</sup>

A buy-sell agreement should set forth the triggering events with particularity. Common triggering events include death, retirement, disability, expulsion, sale or gift of the stock, bankruptcy, and divorce when there is joint ownership by spouses.

The agreement should provide for a method of determining the sales price which must be sufficiently capable of being ascertained by the given method;<sup>198</sup> however, courts may not be strictly bound by the chosen method. The agreement should also set forth allowable methods of payment for affected shares. Fixed priced buy-sell agreements have the advantage of sparing surviving shareholders the difficult task of negotiating the sale price with the new stockholder. Heirs and personal representatives are also benefitted by the restriction because it provides both a ready market for the stock and a basis for estate tax valuation that will generally be accepted by the Internal Revenue Service.<sup>199</sup>

If the purchaser cannot fund the purchase or redemption obligation triggered by the contingency, then the agreement and the intentions of the shareholders are frustrated. Thus, many parties to a buy-sell agreement opt to fund the buy-out through insurance policies or other similar arrangements.<sup>200</sup>

The agreement should also set forth whether its terms are permanent or only temporary. If temporary, the duration should be clearly stated. The agreement should also state whether its terms will apply to subsequent stockholders.

The Code specifically allows restrictions for:

- (1) maintaining the corporation's status, if dependent upon number or identity of shareholders; and
- (2) preserving entitlements, benefits, or exemptions under law; or

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of the restriction. *Norman v. Jerich Corp.*, 501 P.2d 305, 307 (Or. 1972).

196. UTAH CODE ANN. § 70A-8-204 (1990) (restrictions imposed by the original issuer of the stock); *id.* § 16-10a-627 (Supp. 1994) (restrictions regardless by whom imposed).

197. *Id.* § 70A-8-204(2) (1990).

198. See HENN & ALEXANDER, *supra* note 39, § 282.

199. 18A AM. JUR. 2D *Corporations* § 688 (1985).

200. The Code recognizes this need and provides that "[a] shareholder or partner has an insurable interest in the life of other shareholders or partners for purposes of insurance contracts that are an integral part of a legitimate buy-sell agreement respecting shares or a partnership interest in the business." UTAH CODE ANN. § 31A-21-104(2)(a) (Supp. 1994).

(3) other reasonable purposes.<sup>201</sup>

Restrictions adopted after issuance of the stock are unenforceable unless the holders of the shares were parties to the restriction agreement or voted in favor of the restrictions.<sup>202</sup>

Pursuant to an agreement, a triggering event may affect any or all of the shares. Upon the occurrence of a triggering event, the agreement may provide that the shares must be purchased by another shareholder (cross purchase), by the corporation (redemption), or by some combination thereof (hybrid).<sup>203</sup>

The Utah Code specifically permits restrictions that assure that the first right of refusal be given to "the corporation or other persons, separately, consecutively, or simultaneously."<sup>204</sup> In addition, restrictions may obligate the transferor to gain authorization from the corporation or the shareholders for the intended transfer. Even prohibitions against the transfer to designated persons or classes of persons are permitted. The requirement, however, must "not be manifestly unreasonable."<sup>205</sup>

The provisions of the Utah Code which address professional corporations require such corporations to purchase a deceased or disqualified shareholder's shares within 90 days of the death or disqualification, unless a shareholder agreement provides otherwise.<sup>206</sup> The purchase price shall be the reasonable fair value of the shares on the date of death or disqualification.<sup>207</sup>

25. *Will any preference be given to certain shareholders in the distribution of current profits of the corporation?*

Common stock is the basic class of stock issued by corporations. Absent other classes of stock having superior rights, or a contrary provision in the articles, the owners of common stock are entitled to a pro rata share in the corporation's profits, dissolution assets, and a vote in management.<sup>208</sup>

Under Utah law, a corporation has the power to create and issue stock with any preferences, limitations, and rights that are clearly stated in the articles of incorporation.<sup>209</sup> The most common preferences are

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201. *Id.* § 16-10a-627.

202. *Id.*

203. *Id.*

204. *Id.*

205. *Id.*

206. *Id.* § 16-11-13.

207. *Id.*

208. 18A AM JUR. 2D *Corporations* § 437 (1985).

209. UTAH CODE ANN. § 16-10a-601 (Supp. 1994).

rights to dividend payments from the earnings of the corporation. The type of dividend preferences should be clearly designated in the articles of incorporation as "cumulative," "noncumulative," or "cumulative-to-extent-earned."<sup>210</sup>

The articles of incorporation may also provide for the division of a preferred class or a special class of stock with preferred characteristics into series. Issuance of a class of stock in series allows variation in the rate of dividend, redemption terms, amount payable on liquidation, sinking fund provisions for redemption, and conversion rights for less than the whole class.

However, if more than one class of shares, or more than one series within a class, "is authorized, the articles of incorporation *must* prescribe a distinguishing designation for each class."<sup>211</sup> In addition, the articles must reflect the "preferences, limitations, and relative rights" of each class of stock before it is issued.<sup>212</sup>

The structure of stock classes must provide for "one or more classes of shares" that together have all the voting rights and the right to receive the "net assets of the corporation upon dissolution."<sup>213</sup> The articles of incorporation may provide for the board of directors to have authority to create special classes and series of stock. All shares within a series must have identical preferences, limitations and rights.<sup>214</sup>

Before issuing stocks created by the resolution of the board, the corporation must file with the Division of Corporations and Commercial Code a statement setting forth the corporate name, a copy of the amendment to the articles of incorporation regarding the stock in question, the date of its adoption, and a statement that the resolution was duly adopted.<sup>215</sup> In addition, if the amendment or resolution alters or revokes any limitations or preferences of a class or series of stock that is wholly unissued, the filing should include a statement that none of the shares effected has yet been issued.<sup>216</sup>

Stock given preferential rights remains part of the capital stock with the same rights and liabilities as common stock, except for the preferenc-

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210. *Id.* § 16-10a-602(3)(c). A cumulative preference requires payment of all prior and current dividends, a noncumulative preference only requires payment of dividends from current earnings, and a cumulative-to-extent-earned preference requires payment of current and prior unpaid dividends only to the extent earnings are available. *Id.* Classes of stock may also be partially cumulative. *Id.*

211. *Id.* § 16-10a-601(1) (emphasis added).

212. *Id.*

213. *Id.* § 16-10a-601(2).

214. *Id.* § 16-10a-602(1).

215. *Id.* § 16-10a-602(4).

216. *Id.*



es authorized and given in accordance with the articles of incorporation.<sup>217</sup> However, S-corporation stock is treated differently. Preferences given to any shareholders in the distribution of profits of a closely-held corporation may be considered a new class of stock and will invalidate or preclude the use of Subchapter S treatment for tax purposes.<sup>218</sup>

Important non-tax factors should also be considered in deciding whether to give certain shareholders preferences in profits distribution, including:

- (1) the willingness of some shareholders to trade growth for current income,<sup>219</sup>
- (2) the cost of issuing and maintaining records on a new class of stock,
- (3) the risk that enough capital to pay preferred stock dividends will not be available, and
- (4) the flexibility of the payment obligation.<sup>220</sup>

26. *Will any preferences or priorities be given to any shareholders on liquidation?*

Upon liquidation, all shareholders of the same class generally participate equally in any net assets of the corporation.<sup>221</sup> However, the articles of incorporation may provide for preferred distribution of assets on liquidation to a particular class of stock or to a class of stock issued in a series.<sup>222</sup> Additionally, the articles of incorporation may provide for a particular class of stock, or for a class of stock issued in a series, shares that:

are redeemable or convertible as specified in the articles of incorporation:

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217. 18A AM. JUR. 2D *Corporations* § 438 (1985).

218. "A corporation will not be eligible to elect to be an S corporation if it has more than one class of stock outstanding unless the only difference between shares of the different classes is a difference in voting rights. . . . [I]n effect, an S corporation may only issue voting and nonvoting common stock. . . . [I]n [some] situations, issuance of debt may serve as effectively as issuing preferred stock in meeting investors' needs, and Subchapter S status will not be effected." (citations omitted) *Id.* § 436. See also, I.R.C. § 1361(c)(5) (1994) (outlining safe harbor requirements for straight debt).

219. 18A AM. JUR. 2D *Corporations* § 438 (1985). Preferred stock may be used in this way to provide for the family of an owner which is interested in a steady cash flow and protection against the stock's downside risks, but not in active participation in the corporation. See *id.*

220. *Id.* n.90 (citing PLANNING PREFERRED STOCK FINANCING, 5 CORPORATE CAPITAL TRANSACTIONS COORDINATOR (RIA) ¶¶ 11,201 et seq. (Apr. 25, 1990)).

221. CAVITCH, *supra* note 47, § 190.01.

222. UTAH CODE ANN. § 16-10a-601(3)(d) (Supp. 1994).

- (i) at the option of the corporation, the shareholder, or another person or upon the occurrence of a designated event;
- (ii) for money, indebtedness, securities, or other property; or
- (iii) in a designated amount or in an amount determined in accordance with a designated formula or by reference to extrinsic data or events.<sup>223</sup>

For example, the articles may provide for a greater liquidation preference for a voluntary than for an involuntary liquidation.<sup>224</sup>

Liquidation preferences in the articles of incorporation should also clearly provide whether the stock is participating or nonparticipating with other classes of stock in the distribution of net assets remaining after the designated preference.<sup>225</sup> Liquidation preferences are usually given in terms of either par value or a monetary amount.<sup>226</sup> Rights to dividend arrearage liquidation also need to be clearly defined in the articles of incorporation.<sup>227</sup>

## 27. *Is it clear which stock will qualify as Section 1244 stock?*

Whenever a corporation issues stock and the contributions to capital and paid-in surplus for the stock and all previously issued stock does not exceed \$1 million, the corporation will by definition be considered a "small business corporation."<sup>228</sup> The stock of the small business corporation will automatically be considered Section 1244 stock if the following are met:

- (1) the stock cannot be converted into other securities;
- (2) the stock was issued by the corporation for money or other property, but not for stock or securities; and
- (3) more than 50% of the corporation's aggregate gross receipts for the 5 most recent taxable years (ending before the date the loss of the stock was sustained) is derived from sources other than royalties, rents, dividends, interest, annuities, and sales or exchanges of stocks or securities.<sup>229</sup>

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223. *Id.* § 16-10a-601(3)(b).

224. HENN & ALEXANDER, *supra* note 39, § 383.

225. *Id.*

226. *Id.*

227. *Id.*

228. I.R.C. § 1244(c)(3) (1994).

229. *Id.* § 1244. For a detailed discussion of the history of interpretation and application of Section 1244, see Gregory J. Naples, *Section 1244, Small Business Stock Losses: A Reacquaintance that will Survive Tax Reform and a Proposal for Change*, 71 MARQ. L. REV. 282 (1988). For a discussion of potential problems with qualifying stock under Section 1244 when a partnership incorporates, see Richard J. Mathias, Note, *Incorporating a Partnership under Revenue Ruling 84-111: A New Literal Code Application Approach*, 40 TAX LAW. 779

Such treatment is important because the individual or partnership to whom the stock was originally issued will be entitled to ordinary (as opposed to capital) loss treatment on any sale, redemption, exchange, or worthlessness of Section 1244 stock up to \$50,000 per taxable year (\$100,000 on a joint return).<sup>230</sup> The possibility that such stock could lose its Section 1244 status should not discourage the corporation from attempting to qualify each stock issue as Section 1244 stock because gain or loss on disqualified Section 1244 is taxed no more severely than stock which never qualified.

Making a Subchapter S election does not preclude the application of Section 1244. A Subchapter S election in this situation will permit a "small business corporation" to pass through its losses on its activities each year and still allow the original owners of the stock to receive ordinary loss treatment from any remaining taxable loss on the stock when it is sold, redeemed, exchanged, or becomes worthless.

### 28. *Do the securities laws apply to closely-held corporations?*

The securities laws are often a trap for the unwary. Many parties involved with closely-held corporations are unaware of the broad coverage of federal and state securities laws and do not realize that the securities laws apply both to publicly-held and closely-held corporations.

The term "security" is defined in both federal and state securities laws to include, among other things, stocks and bonds.<sup>231</sup> For those instruments not specifically defined, the test commonly employed by the courts to determine whether an interest is a security is whether the scheme involves an investment of money in a common enterprise with profits to come from the marginal efforts of others.<sup>232</sup> Consequently, if a closely-held corporation issues stock, bonds, or any other type of investment contract, the transaction will likely fall within the scope of the securities laws.

The purpose of the securities laws is to protect the investing public through disclosure. To accomplish this, the securities laws generally require that the issuer of securities, prior to the offer of such securities in interstate commerce, file with the SEC a registration statement containing information concerning the security, the issuer, and the underwriters.<sup>233</sup> This information is then made available to the public.

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(1987).

230. I.R.C. § 1244(b) (1994).

231. See The Securities Act of 1933 § 2(1) [hereinafter SA]; UTAH CODE ANN. § 61-1-13(22) (Supp. 1994).

232. See SEC v. W.J. Howey Co., 328 U.S. 293 (1946).

233. See SA, *supra* note 231, § 5.

The cost of disclosure places a heavy burden on the issuer because of the time and costs associated with preparing a registration statement. There are, however, several exemptions to the registration requirement for which issuers of securities, such as closely-held corporations, may qualify.

#### A. *Federal exemptions*

The Securities Act of 1933 and the regulations thereunder contain exemptions from the registration requirements for offers and sales of securities where the issuer, the securities, or the transaction meets certain statutory requirements.<sup>234</sup> The reasoning behind the exemptions is that under certain circumstances there is no practical need for registration or the benefits of registration are too remote.

Typically, the circumstances surrounding most closely-held corporations will allow them to achieve exempt status. A summary of the most commonly used exemptions is presented below. However, a closely-held corporation should carefully review the statutory and regulatory provisions governing these exemptions before issuing any security.

1. *Limited offering exemptions under Regulation D.* Regulation D<sup>235</sup> is the safest and surest way to avoid the registration requirement of the Security Act and is therefore the most commonly used exemption. In general, Regulation D provides for two types of limited offering exemptions that differ primarily in the amount of money and number of purchasers involved in the offering.<sup>236</sup> In particular, Rule 504 exempts offerings of up to one million dollars to an unlimited number of purchasers, while Rule 505 exempts offerings of up to five million dollars to a limited number of purchasers. Neither exemption restricts the nature or sophistication of the purchasers.

An issuer offering or selling securities in reliance on Regulation D must file notice with the SEC, using Form D, of that offering no later than 15 days after the first sale of the securities.<sup>237</sup> Filing a Form D notice is quite simple and is much less costly and burdensome than filing a complete registration statement.

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234. See SA, *supra* note 231, §§ 4, 5.

235. SA, *supra* note 231, REGULATION D—LIMITED OFFERINGS.

236. Regulation D also provides for two additional exemptions which are in the nature of private offerings: (1) a private offering made only to accredited investors; and (2) a private offering to a limited number of sophisticated purchasers. Unlike Rules 504 and 505, there is no aggregate offering price limitation on these exemptions.

237. See SA, *supra* note 231, REGULATION D, Rule 502.

2. *Other exemptions.* There are other exemptions in addition to Regulation D, but unless the closely-held corporation cannot qualify for Regulation D or unless the circumstances otherwise dictate the use of another exemption, Regulation D is advisable. Several of these other exemptions are summarized below.

(a) *Intrastate sales exemption.* Under section 3(a)(11) of the Security Act, any security that is a part of an issue offered and sold only to residents within a single state or territory is exempt from the registration requirement of the Security Act when the issuer of such security is also a corporation incorporated and doing business within the state or territory. This statutory exemption is applied very narrowly; even a single sale or offer to sell to a nonresident will render the entire issue ineligible for the exemption. Therefore, it is advisable to comply with Rule 147 of the Securities Exchange Act of 1934,<sup>238</sup> the "safe harbor" provision associated with section 3(a)(11). Rule 147 sets forth several technical requirements that must be met to presumptively establish the existence of the intrastate offering exemption.

(b) *Private placement exemption.* Under section 4(2) of the Security Act, transactions by an issuer not involving public offerings are exempt from the registration requirement. The Security Act does not define "public offering," but case law has made it clear that the exemption is intended to permit an issuer to make sales to particular persons who are able to fend for themselves and who have access to sufficient information so that they do not need the protection of the registration requirement of the Security Act.<sup>239</sup>

To help corporations safely avoid the registration requirement, Rule 506 of the Securities Act, a part of Regulation D, offers a "safe harbor" for the private placement exemption.<sup>240</sup> This rule permits offers and sales of securities by an issuer to be deemed transactions not involving any public offering within the meaning of section 4(2) of the Securities Act if (1) sales are not made to more than a specified number of purchasers; (2) all purchasers meet certain specified qualifications as to their sophistication with respect to investments; and (3) the remaining specified provisions of Regulation D are satisfied.

(c) *Small Offering exemption under Regulation A.* Regulation A exempts from the registration requirement certain security issues having aggregate offering prices of not more than five million dollars, provided the requirements prescribed therein are met.<sup>241</sup> The requirements are

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238. The Securities Exchange Act of 1934, Rule 147 [hereinafter SEA].

239. See SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

240. See SA, *supra* note 231, REGULATION D, Rule 506.

241. See SA, *supra* note 231, REGULATION A, Rule 251(b).

generally similar to the registration requirements of nonexempt issues but are less stringent. Consequently, Regulation A is often referred to as a "mini registration," but it should be noted that it is not deemed to be a registration statement under the Security Act. In order to be entitled to an exemption under Regulation A, the issuer must file seven copies of an offering statement with the SEC.<sup>242</sup>

### B. State Exemptions

In addition to federal securities laws, every jurisdiction has state blue sky laws. Unlike federal securities laws which focus primarily on national markets, blue sky laws are aimed primarily at new and unproven concerns and speculative ventures which often have local or regional impact. Consequently, a closely-held corporation that is exempt for the registration requirement under federal securities laws is not necessarily exempt under state law. However, in states like Utah that have passed a version of the Uniform Securities Act in an attempt to streamline the filing procedures of the federal and state laws, certain issuers are able to register with the state either "by notification"<sup>243</sup> or "by coordination."<sup>244</sup> However, if this is not available, the issuer will have to qualify for an exemption under state law.

1. *Limited Offering exemption.* The Utah limited offering exemption<sup>245</sup> is patterned after the Uniform Limited Offering Exemption which was adopted to coordinate with Regulation D of the Security Act in an attempt to introduce some uniformity with respect to limited offerings. Like Regulation D in the federal act, the limited offering exemptions is perhaps the most used state law exemption. Since the requirements of this Utah state exemption differ in certain respects from those of Regulation D, closely-held corporations should carefully review all these requirements before issuing securities.

2. *Other exemptions.* Fewer exemptions are available to issuers under state law than under federal law. The nonpublic offering exemption is similar to section 4(2) of the Security Act. It provides that any transaction not involving a public offering is exempt from the state registration requirement. Other exemptions include transactions with

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242. See SA, *supra* note 231, REGULATION A, Rule 251(e).

243. In general, any security whose issuer and any of its predecessors have been in continuous operation for at least five years may be registered by notification. UTAH CODE ANN. § 61-1-8 (Supp. 1994).

244. "Any security for which a registration statement or a notification under Regulation A or any successor to Regulation A has been filed under the Security Act of 1933 in connection with the same offering may be registered by coordination." *Id.* § 61-1-9(1).

245. See *Id.* § 61-1-14(2)(n).

nonprivate financial institutions<sup>246</sup> and transactions with existing security holders.<sup>247</sup>

### *C. Criminal and Civil Liability Provisions*

The above exemptions serve only to exempt closely-held corporations from the burdensome and costly requirements of filing a registration statement. They do not exempt closely-held corporations from certain federal and state criminal and civil liability provisions based on material misrepresentations or omissions.<sup>248</sup>

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246. *See id.* § 61-1-14(2)(h).

247. *See id.* § 61-1-14(2)(j).

248. *See SA, supra* note 231, §§ 12, 17; *SEA, supra* note 238, § 18 & Rule 10b-5.